

## SEC Describes Active Enforcement Program and Focus on Corporate Conduct in 2019 Annual Report

November 14, 2019

**The SEC's Enforcement Division (the "Division") released its annual report on November 6. The Division filed 7% more standalone cases in 2019 than it did in 2018, and financial sanctions increased by 10%. The Division obtained these results despite several programmatic challenges, including the Supreme Court's decision in *Kokesh v. SEC* applying the five-year statute of limitations to SEC disgorgement claims. In addition to bringing a large number of traditional corporate cases in connection with alleged fraud, disclosure, internal controls, accounting, and FCPA violations, the Division signaled its continuing focus on retail investors and cyber-related misconduct. In the coming year, and based on the success of the Division's Share Class Selection Disclosure Initiative (which accounted for nearly one-fifth of the Division's standalone cases this year), we expect that the Division will continue to look for ways to blend its mandate of protecting retail investors while still bringing cases against large issuers and financial institutions –perhaps through additional self-disclosure initiatives that can yield big impact with fewer dedicated resources.**

### *Fiscal Year 2019 Annual Report*

At the end of its fiscal year, the SEC publishes a corporate-style annual report that sets out its enforcement statistics. In addition to focusing on the number of cases filed, the amount of relief ordered, and the amount of money returned to investors, it highlights the most important cases of the year.<sup>1</sup>

This year, the SEC initiated 862 enforcement actions, including 526 standalone actions brought in federal court or as administrative proceedings. This is the highest number of cases brought since fiscal year 2016 and covered a breadth of topics beyond the SEC's stated enforcement priorities of retail investors and cyber, including 144 issuer financial reporting, disclosure, and auditor-related actions, 18 FCPA actions, and more than 20 actions against financial institutions. The SEC also obtained a total of over \$4.4 billion in total monetary remedies, the highest amount obtained in the last five years.

As always, the annual report begins with a "message" from the Co-Directors that summarizes the key areas of focus of the Division. While the Co-Directors' message begins with a summary of the Division's work in protecting retail investors, it quickly pivots to a discussion of the financial fraud and disclosure cases that capture large monetary remedies from issuers and financial institutions, noting that these cases demonstrate the SEC's "willingness to punish significant corporate wrongdoing." The Co-Directors highlight a number of large accounting disclosure cases with multi-million dollar penalties that cover a number of different issues, including allegations of misleading risk factor disclosures, untimely accrual for

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<sup>1</sup> The Division began issuing a corporate-style annual report in 2017. The annual reports provide a narrative of the Division's work, including the principles the Co-Directors use to guide their oversight of the Division, as well as the quantitative metrics on cases filed and relief ordered. The 2017 annual report identified five principles, which have remained a constant in each report since: (1) focus on the main street investor; (2) focus on individual accountability; (3) keep pace with technology change; (4) impose sanctions that most effectively further enforcement goals; and (5) constantly assess the allocation of resources.

and disclosure of potential liability from a DOJ investigation, inflated monthly sales results, failure to disclose executive compensation, and misstatements and misclassification of certain income. Demonstrating its commitment to pursuing issuers for disclosure violations, the Division also brought its first standalone Regulation FD action since 2013. The Co-Directors' message also highlights large sanctions against financial institutions, including a series of cases against large financial firms in connection with street-wide practices involving the pre-release of American Depository Receipts ("ADRs"), which generated more than \$425 million in disgorgement and penalties from 13 firms over the past two years.

Finally, the annual report describes enforcement efforts in several other areas, including the Division's use of technology to detect suspicious trading, and cyber-related enforcement cases, such as the case against nine defendants for an alleged scheme to hack into the SEC's EDGAR system and extract nonpublic information to use for illegal trading. The report also discusses the Division's enforcement cases involving digital assets. These include several "first-ever" cases, such as a case for alleged unlawful celebrity promotion of initial coin offerings ("ICOs"), a case involving an individual who founded a digital asset trading platform without registering the exchange with the SEC, and the SEC's first-ever litigated case against a digital asset issuer solely for failing to register a securities offering.

### ***The Division's Future Focus***

Consistent with the SEC's focus on main-street investors, the annual report highlights the results from the Division's Share Class Selection Disclosure Initiative, in which the Division invited investment advisers to self-report instances in which they recommended that retail investors purchase mutual fund share classes that had higher fees than other share classes that the investors were eligible to purchase. The Division said that it would not recommend penalties against advisers that self-reported such conduct that fell within certain defined criteria.

In a speech given in London the day before the Division released the annual report, and underscoring the success of the Share Class Selection Disclosure Initiative, Enforcement Co-Director Stephanie Avakian signaled that the Division's future targets will include other alleged undisclosed material conflicts. Avakian listed several account arrangements that the Division is investigating as presenting potential conflicts of interests:

1. Clearing Broker Platforms. Avakian noted that some clearing brokers charge fees to mutual funds for access to their platform, and sometimes the broker shares those fees with an introducing broker that might also be dually-registered as or affiliated with an investment adviser. According to Avakian, such an adviser might be conflicted when choosing mutual funds because some of those funds may generate revenue for its affiliate.
2. Cash Sweep Accounts. Avakian referred to cash in advisory accounts being swept into money market mutual funds or bank deposit sweep programs, and said that a dually-registered adviser or an adviser with an affiliated broker-dealer might have a financial interest in selecting cash investments that produce greater income for the adviser or its affiliate.
3. Unit Investment Trusts (UITs). Avakian described unit investment companies that hold a fixed portfolio of securities for a specific time before distributing the proceeds to investors. Avakian noted that these UITs have different sales charges for different types of sales channels, and that the fee structures may create conflicts for dually-registered advisers who may be inclined to recommend the fee structure most favorable to it or its affiliate.

4. Retirement Accounts for Teachers. The SEC recently announced an enforcement and investor education initiative concerning investment accounts for teachers, especially retirement accounts.<sup>2</sup> Avakian said that the SEC is “looking at the compensation and sales practices of third-party administrators of teacher retirement plans . . . as well as the practices of their affiliated advisers and broker-dealers,” including the selection of investment options.

The SEC currently focuses these initiatives on products that involve advisory accounts because investment advisers have a fiduciary duty to their clients. However, as explained in our recent [Visual Memorandum](#), the SEC recently adopted Regulation Best Interest (“Reg BI”), which will require broker-dealers to act in the best interest of a retail customer when making recommendations regarding securities transactions or investment strategies to such customers.<sup>3</sup> The compliance date for Reg BI is June 30, 2020.<sup>4</sup> The first stage of regulatory oversight likely will be a wave of examinations, potentially followed by enforcement attention. The SEC’s search for perceived conflicts of interests in advisory accounts could expand to broker-dealers shortly after the industry has transitioned to Reg BI.

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The message from the annual report is that, while the Division’s stated focus is on retail investors and cybersecurity threats, it will continue to be active in policing alleged corporate misconduct. Much of the Division’s increased productivity over the prior year can be attributed to the Share Class Disclosure Initiative and sweeps for street-wide conduct that can yield multiple standalone cases and substantial monetary sanctions against large financial institutions without requiring the resources of dozens of individual investigations. While touting its record numbers, the Division also discussed several “headwinds” that it confronted, including Supreme Court rulings [limiting its ability to seek disgorgement](#) and [declaring unconstitutional](#) aspects of the SEC’s administrative proceeding program, as well as the 35-day government shutdown and staffing challenges. The suggestion is that the Division’s metrics (and perhaps the number of financial fraud and other headline-grabbing cases involving issuers and large institutions) would have been even greater but for these challenges. We expect the Division to continue its broad-based enforcement program in the upcoming year, including with respect to cases involving financial fraud and issuer disclosure, accounting, and internal controls failures.

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<sup>2</sup> At the same time, the SEC also announced an initiative concerning military service members. See “SEC Announces Enforcement and Investor Education Initiatives to Protect Teachers and Military Service Members,” (June 3, 2019) (available at <https://www.sec.gov/news/press-release/2019-85>).

<sup>3</sup> See “SEC Adopts Rules and Interpretations to Enhance Protections and Preserve Choice for Retail Investors in Their Relationships with Financial Professionals,” (June 5, 2019) (available at <https://www.sec.gov/news/press-release/2019-89>).

<sup>4</sup> *Regulation Best Interest: The Broker-Dealer Standard of Conduct*, 84 Fed. Reg. 33318, 33400 (July 12, 2019).

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